



RISK: A PUBLIC PERSPECTIVE

CPPIB's framework for a funded future. . . with minimal risk.

VALTER VIOLA *Vice-president, research and risk management, Canada Pension Plan Investment Board.*

Many in the pension fund industry have long realized that a lack of focus or clear mission is one of the major barriers to overcome, and having a dynamic risk-based culture is critical to survival. The Canada Pension Plan Investment Board (CPPIB) story reflects the truth of that statement. During our five-and-a-half-year operating history, the CPPIB has developed a risk management culture based on a clear mission: to build and diversify the reserve fund of the Canada Pension Plan in the best interests of contributors and beneficiaries by investing to maximize long-term returns without undue risk. To support this goal, the CPP Investment Board has adopted an enterprise-wide risk management framework, which includes a risk-adjusted performance benchmark for measuring success.

When we were created as a Crown corporation in 1997 the CPP was in crisis, with an annual shortfall of \$6 billion. At that time, reserve assets consisted of government bonds and short-term securities. Today, the CPP is on firmer ground: assets stand at more than \$70 billion, roughly half of which are bonds, with the remainder in equities and real-return assets such as real estate and infrastructure. Although short-term returns are volatile, reserve assets are projected to reach \$190 billion within a decade, making the CPP one of the world's largest pension funds.

Our progress so far—and our future prospects—rest with the corporate governance structure designed by the CPP Investment Board's architects, the federal and provincial governments. This governance structure balances independence from government with accountability to Parliament, the provinces and the people of Canada, and gives us freedom to make long-term investment decisions and meet our fiduciary responsibilities to Canadians without political interference.

Using this governance structure, we have taken a total balance-sheet approach to managing investment risk. The Chief Actuary has estimated that a 4% real rate of return is necessary to sustain the CPP over the long term. The main investment risk, which we call Capital at Risk, is the possibility that CPP reserves will not rise as

fast as the liabilities, taking into account the funding of the CPP. In other words, our primary investment risk is that returns fall short of those on our "minimum risk portfolio" (MRP), which takes into account both the CPP's liabilities and its funding.

Concepts like the MRP and Capital at Risk form part of the investment framework we've built to manage investment risk. The framework also includes investment beliefs, which allow us to make informed decisions in a holistic way—such as how much risk to take, where to take it and what compensation we should expect in return, as well as other beliefs, such as those related to market efficiency over various time horizons.

In this context, our focus is on risk allocation rather than asset allocation. Asset allocation is the outcome of our dynamic risk allocation process, not the other way around. While the 4% real return assumption is a key line in the sand, the MRP captures changes in the value of the liabilities and is a better benchmark against which to measure the CPP reserve fund's contribution to sustainability, all else being equal. Risk-adjusted net value added (RANVA) is our standard and the benchmark for measuring it is the MRP, taking into account both the costs and the risks of not investing in that benchmark.

Still, the future success of the CPP is about more than managing the risk of our investment capital. We believe our future success depends mainly on our capability to translate our corporate values, such as teamwork and innovation, into action—overcoming the primary barrier to excellence identified by pension executives almost a decade ago, which was poor process (including structure and inertia). By protecting and strengthening our structural capital—such as our governance structure, risk-based culture and investment framework—we can add more value to our pool of investment capital. This may seem abstract and uncommon, but we think it is important to make it practical and commonplace at the CPP Investment Board if we are to realize our full potential as the long-term agent of CPP sustainability. ■